

Investment Monitoring Policy
Howard County General Employees Retirement Plan and
Police and Fire Employees Retirement Plan

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Introduction:

The Howard County Retirement Plan and the Howard County Police and Fire Employees Retirement Plan (collectively “the Plans”) invest a combination of investment earnings on the Plans’ assets and contributions in accordance with a separately issued **investment policy** that includes permissible investment types and a target portfolio allocation. The primary objective of this investment monitoring policy is to formally document the County’s policies and procedures, internal controls and documentation requirements for monitoring investments. It also includes the procedures for addressing the accounting and financial reporting requirements of Governmental Accounting Standards Board (GASB) Statement No. 72 “Fair Value Measurement and Application,” especially in terms of understanding the nature of and the pricing/valuation methods used by the respective fund managers for these investments, and also determining the related fair value measurements and disclosures.

The procedures shall address how investments are selected and monitored on an ongoing basis, and include the following areas: the initial due diligence, risk assessment, ongoing monitoring, and financial reporting. These procedures will be performed by the Plans’ investment consultant, the trustees of the Plans (aka, The Retirement Plan Committees) and management of Howard County.

The Plans’ trustees and management of Howard County are responsible for the administration, compliance monitoring and oversight of this policy.

A) Initial Due Diligence Procedures

Initial Due Diligence is performed prior to selecting a new fund manager or investment. The following procedures are initiated and performed by the Plans’ investment consultant and supported by the trustees of the Plans and legal counsel.

- 1) Perform quantitative and qualitative analysis of a fund manager’s investment style and process and assess the effect the investment would have on the portfolio.

- 2) Assess the fund manager's personnel, operations, controls, systems, policies and procedures through on-site front office reviews, as well as review key legal, tax and compliance issues. Consider risks associated with a potential mismatch of liquidity terms between a fund's investments and the liquidity terms of the fund.
- 3) Present the top candidates including a process, due diligence, and firm summary to the trustees of the Plans in order for an investment sub-committee to be formed for interviewing the candidates.
- 4) Document the formal due diligence with a summary report, recommendations, and approvals as indicated in the written minutes of meetings where decisions regarding investment manager selection were made.

B) Risk Assessment Procedures

- 1) All relevant risk factors of each investment must be assessed, as there are varying structures and strategies associated with the different investments. The risk assessment process is especially critical for "Alternative Investments".

An alternative investment is defined as an asset that is not one of the conventional investment types, such as stocks, bonds and cash. Most alternative investment assets are held by institutional investors or accredited, high-net-worth individuals because of the complex natures and limited regulations of the investments. Alternative investments include private equity, hedge funds, real assets/estate, commodities and derivatives contracts.

Each investment must be assigned scores based on specified criteria (see five criteria below) and then categorized into different risk categories, namely low, moderate and high risk. Procedures will then be designated for each risk category to provide adequate comfort, given the relative risk rating (e.g., more robust procedures and controls for the high-risk category). To this end, management will create and maintain an investment matrix, listing the

various investments in the portfolio by fund manager and scoring each of the following five criteria out of a total of 13 possible points to result in an assigned risk level (with 4-7 points representing a high-risk investment, 8-10 points representing moderate risk and 11-13 points representing low risk):

- a. **Quality of management** (1-3 points with 1 representing a low quality and 3 representing a high quality) based on the following factors:
 - i. Quality and experience of fund management
 - ii. Role and effectiveness of fund governance
 - iii. Quality of service providers
- b. **Liquidity and Complexity** (1-3 points with 1 representing an illiquid or complex investment and 3 representing a highly liquid investment), based on the following factors:

The effort needed to support the valuation and existence assertions is greater for a more complex or illiquid fund than for a less complex and more liquid fund. Typically, there should be a general correlation between the liquidity of the fund's investment portfolio and the liquidity terms of the fund itself (i.e., redemption provisions).

- i. **Hedge Funds** – Hedge funds may have complicated capital structures and related liquidity terms, which may affect fair value considerations, such as:
 - a) Legal structures – for example, the use of a corporate form for most offshore funds (as opposed to a limited partnership form for most domestic funds) imposes certain complexities on the capital structure.
 - b) Liquidity of the underlying investment portfolio – there are often specified terms regarding when withdrawals or redemptions are permitted under the limited partnership agreement (e.g., monthly, quarterly, semi-annually, annually), subject to notice. There may also be the use of side-pocket accounts and other liquidity terms such as initial lock-ups, the ability to withdraw with penalties, notice periods, holdbacks and gates which all impact the determination of fair value and the risk assessment.

- c) Prevalence and mechanisms associated with performance-based fee arrangements
- ii. Private Equity Funds (comprising buyout, venture capital, mezzanine and other similar strategies) – these funds typically do not provide for limited partner-initiated redemptions as the funds have limited lives, often 8 – 10 years. Therefore, unless the interest is sold in the secondary market, there is limited opportunity to withdraw before the fund is terminated. As a result, interests in private equity funds are less liquid than interests in hedge funds. Also, unlike hedge funds, private equity funds do not continuously raise capital. Rather, a specified amount of capital is committed upon inception of the fund which is then drawn down over a specified period of the fund’s life at specified intervals. Finally, they generally invest in the equity and/or debt securities of private companies.
- iii. Real Assets Funds - This represents funds that invest in institutional real estate (office, multi-family, industrial, and retail) and natural resources strategies. The fair values of the investments in these strategies are determined using the NAV per share (or its equivalent) of the Plans’ ownership interest in partnership’s capital.
- iv. International Equity Funds - This represents investments primarily in value oriented equity securities of international developed markets (non-U.S. issuers; e.g. MSCI EAFE) with the objective of achieving a long-term return above a passive benchmark (EAFE).
- v. Commingled Funds - This represents investments primarily in growth oriented equity securities of international developed markets (non-U.S. issuers; e.g. MSCI EAFE). The objective of this fund is to achieve long-term growth of capital and a return above a passive benchmark (EAFE) by identifying publicly traded equities with strong growth prospects.
- c. **Pricing/Valuation Methodology and Reporting** (1-2 points with 1 representing that the fund manager does not have a transparent, timely and GASB 72 compliant valuation and reporting process and 2 representing that it does have such a valuation and reporting process).

Management will review the audited financial statements to determine if the entity/partnership:

- i. received an unmodified opinion
- ii. used an acceptable method of accounting (i.e., accounting principles generally accepted in the United States known as “GAAP”) and disclosed significant accounting policies
- iii. measured the investments at fair value in accordance with the authoritative guidance, and
- iv. disclosed significant risk factors such as liquidity risk, currency risk, and investment risk.

The evaluation of the valuation and reporting process should be performed with a clear understanding of the underlying investment portfolio held in each fund which can be acquired by attending the fund managers’ presentation to the Committee and the quarterly performance review by the plans’ investment consultant or by having further discussion with the consultant, if needed.

- d. **Internal Controls** (1-2 points with 1 representing adequate internal controls and 2 representing strong internal controls by reviewing the fund’s SOC 1 Type 2 report, if available), based on the following factors:
 - i. Adequacy of infrastructure, personnel and general internal controls
 - ii. Design and effectiveness of valuation policies and procedures
 - iii. Quality of risk monitoring
 - iv. Impact of regulatory compliance matters
- e. **Materiality** (Any investment representing 0-3% of total materiality will be assigned 3 points, 4-6% will be assigned 2 points and over 7% will be assigned 1 point.) The materiality and significance of each investment by fund manager should be calculated as a percentage of the investment’s fair value out of the total portfolio.

C) Ongoing Monitoring Procedures

Ongoing Monitoring requires an ongoing analysis of investment results and risk/return objectives' compliance with the separately issued investment policy (types and percentage of asset classes), as well as ensuring the fund manager has adequate controls, systems, policies and procedures in place. The nature and extent of procedures performed in this section will vary depending on the level of risk assigned to the fund manager on the Investment Matrix. The Plans' investment consultant will perform the following procedures.

- 1) Obtain sufficient information on the underlying fund and investments by performing the following:
 - a. Conduct periodic interviews to update the understanding of the fund strategy, positions, exposures and key performance drivers. For low risk investments, tri-annual interviews are sufficient. For moderate risk investments, bi-annual interviews are needed. For high risk investments, annual interviews are required. These visits must be documented in writing and reviewed by the trustees of the Plans and by management (i.e., minutes of pension committee meetings).
 - b. Monitor the fund's performance against the benchmark return. Reports documenting this analysis are presented to the trustees of the Plans and discussed in detail (e.g., quarterly performance report).
 - c. Review periodic investor reports and notices and update the trustees of the Plans on significant changes.
- 2) On a regular basis, ask the fund manager via phone calls or on-site visits about any changes in the fund's valuation policies and procedures, including the valuation methodologies, key inputs and assumptions.
- 3) For hedge funds, inquire and understand movements to/from "side pocket accounts" maintained by the fund and any related valuation changes for "side pocket investments."
- 4) Attend the fund manager's annual investor conference, if possible. This may also be performed by the trustees.

D) Financial Reporting Procedures

1. On an annual basis, management will obtain a copy of the fund managers' control reports, if available, to ensure a clean audit opinion (unmodified) was issued.
2. On an annual basis, with an understanding of portfolio holdings, management will review valuations prepared by fund managers, in order to ensure that the following points are addressed:
 - a. Investments with "quoted market prices" are categorized as level 1 investments, those with "observable inputs/prices" as level 2 investments, those with "unobservable inputs" as level 3 and those that meet the NAV criteria (see below) as NAV investments.
 - b. In cases where the Plans invested in the fund itself rather than in the funds' underlying securities, the following criteria must be met in order to use NAV instead of fair value:
 - i. The investee/entity's fair value is not readily determinable - if it is, then use the determined FV instead of NAV (the fair value of the entity's assets & liabilities).
 - ii. It is not probable that the government will sell all or a portion of its investment in the investee/entity at an amount that is different from the NAV per share.
 - iii. The investee/entity's NAV is calculated as of the government's measurement/report date - if it is not, then the most recent NAV (the fair value of the entity's assets & liabilities) needs to be rolled forward to the government's report date.
 - iv. The investee/entity's NAV was calculated in a manner consistent with the FASB's measurement principles for investment companies - meaning, the entity/investee reports all of its assets & liabilities at fair value basis rather than at income tax basis/OCBOA. Also, when relying on Account Statements as of the report date instead of the entity's audited financial statements, verify that these Account Statements were also prepared at fair value basis.

3. On an annual basis, management will review each fund's audited financial statements as follows:
 - a. Compare the unaudited net asset values (NAV) received at the fund's year end date (often December) to the information included within the audited financial statements. This comparison should be relied upon in order to identify any significant adjustments and validate the accuracy of the information provided in the quarterly statements.
 - b. Roll-forward the balance from the fund's latest quarterly statement to the Plans' year end. Upon receipt of the quarterly statements that coincide with the Plans' year end, update net asset values for the financials.
 - c. Review the notes to the financial statements for any disclosure that could impact the risk assessment calculation.
4. On an annual basis, management will ensure compliance with all pension-related GASB Statements, including Statements No. 67, 68 and 72, as well as future GASB Statements.

GLOSSARY

AICPA – American Institute of CPAs, the world's largest member association representing the accounting profession sets ethical standards, auditing standards and develops the CPA Exam.

Fair value – The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

GASB – The Governmental Accounting Standards Board (GASB) was organized in 1984 by the Financial Accounting Foundation to establish standards of financial accounting and reporting for state and local governmental entities. Its standards guide the preparation of external financial reports of those entities.

Level 1 inputs – Quoted prices (unadjusted) in active markets for identical assets or liabilities that a government can access at the measurement date.

Level 2 inputs – Inputs other than quoted prices included within Level 1 that are observable for an asset or liability, either directly or indirectly.

Level 3 inputs – Unobservable inputs for an asset or liability.

Lock-up - A **lock-up** period is the minimum investment holding period required by hedge funds.

Measurement date – The date as of which the fair value of an asset or liability is determined.

Net asset value per share (NAV) – The amount of net assets attributable to each share of capital stock outstanding at the close of the period. It is calculated as (assets less liabilities) divided by outstanding shares.

Observable inputs – Inputs that are developed using market data, such as publicly available information about actual events or transactions, and which reflect the assumptions that market participants would use when pricing an asset or liability.

OCBOA - The term used for a comprehensive basis of accounting other than generally accepted accounting principles.

Side Pocket account - A type of account used in hedge funds to separate illiquid assets from other more liquid investments.

SOC report (Service Organization Control Report) - A series of accounting standards that measure the control of financial information for a service organization.

A Type I report is intended to cover the service organization's system description at a specific point in time (e.g. June 30, 201x). A Type II report not only includes the service organization's system description, but also includes detailed testing of the service organization's controls over a minimum six-month period (e.g. January 1, 201x to June 30, 201x) - also known as Tests of Operating Effectiveness.

EXHIBIT A – ROLES AND FIDUCIARY RESPONSIBILITIES OF EACH PARTY

	Investment	Plans'	County
	<u>Consultant</u>	<u>Trustees</u>	<u>Management</u>
Initial Due Diligence	√	√	-
Risk Assessment	-	√	√
Ongoing Monitoring	√	√	-
Financial Reporting	-	-	√